17. USWC argues that the Telecom Act says USWC must allow resale at wholesale rates, discounted from retail rates. This means, it says, that the imputation subsidy for consumers would flow to the resellers who compete with USWC. Imputation denies USWC equal protection.

The Commission rejects this argument. Imputation will not benefit resellers, as the critical issue for resale is the spread (the difference between USWC's retail rate and the wholesale rate at which a reseller purchases it) and not the base on which the spread is calculated. The Commission is not, in any event, "crediting" imputed sums to any class of ratepayer.

18. The Company argues that imputation here is arbitrary and capricious. It cites WUTC v. Washington Natural Gas Co., UG-920840 (4th Supp. Order), contending that there, the Commission rejected Public Counsel's suggestion to attribute merchandising revenues to regulated activities. The Company states that the Commission is arbitrarily treating USWC differently from WNG.

The Commission rejects the Company's arguments. USWC miscites this order. In the cited order, the Commission was directing WNG to provide sufficient information to assure the Commission that operations were segregated and ratepayers were not subsidizing merchandizing operations. The Company has also cited, so is aware of, the statute preventing the Commission from attributing merchandise sales revenues to regulated operations.

Having found the appropriate calculation of the adjustment, and concluding that the Commission has the power to make the adjustment, the final question is whether the adjustment should be ordered.

The Company argues that it is inappropriate to subsidize exchange rates in a currently competitive market, and that the subsidy proposed by staff and Public Counsel/TRACER will stifle any potential competition. The Company argues that USW Direct does not have a monopoly, and identifies numerous other directories published in the state of Washington. We have noted above that whether or not the directory company has a monopoly in directory marketing is not critical to the decision. We find that it certainly has advantages through the relationship between these affiliates that other directory companies do not have. We note Mr. Brosch's comment that no competitor for local exchange service has ever complained about imputation. We find that imputation is not shown to affect adversely any competition for local exchange service, although we commend USWC for being an advocate on behalf of potential competition. We reiterate that in any event we do not attribute imputed revenues to any customer class.

In making this decision, we also consider the unchallenged fact that the vast majority of USWC's 15 jurisdictions also impute directory revenues. We note USWC's concession on brief that the matter was decided in a prior order. We note (1) Mr. Brosch's testimony that US WEST Direct grossed approximately a billion dollars and earned a return of

205% in 1994, (2) his contention that for Washington operations it earned 229%, and (3) his contention that US WEST Direct's return on equity has exceeded 150% every year since 1989, when publisher fees ended. We find that the segregated US WEST Direct operation did in fact earn substantially more than the authorized utility rate of return on its investment.

We note that an integrated operation would consider those revenues from ratepayers as a part of its operating income. Divesting that operation therefore hurts ratepayers substantially, and should not be done unless protections are in place for ratepayers. Here, imputation provides that protection.

Another analysis supports imputation, as well. The divestiture of a money-producing element of integrated operations so closely related to service without a return benefit appears to have been manifestly imprudent. See, WUTC v. Puget Sound Power & Light Co., Docket Nos. UE-920433/920499/921262 (Consolidated), 19th Supp. Order (Sept., 1994) This adjustment could also be supported on the basis of a prudence analysis.

C. Service Quality

Service quality issues are addressed in Part Three of this Order

III. Operating Expenses

The next general area for study is operating expenses, that is, an examination of the Company's reported expenses in conducting its regulated operations. Ten different areas are in dispute. These adjustments may also have a rate base component; when that is true the adjustment will carry through to rate base in the accompanying table under the same adjustment number.

A. Restructuring PFA-9

During the test period, the Company was conducting a four-year restructuring program, reducing the size of its workforce and reducing the number of customer centers from 560 to 26. It expects substantial savings from the program over time. Most of the costs relate to personnel downsizing -- costs of early retirement and severance. The Company took a one-time pre-tax write-off of $880 million in 1993 relating to restructuring costs financial statement purposes. The Company proposed, then withdrew, an adjustment for this activity.

Commission Staff and Public Counsel/TRACER propose adjustments. They point out the experienced expenses do not represent the ongoing expense level and that the substantial expenses of the program occur in its first three years, while the savings are continuing. They contend that it is improper for ratepayers to pay the expenses in rates, but not receive the benefits of lower expense levels Commission Staff witnesses Ms Strain and Ms Erdahl propose that the

test year costs and benefits be netted and adjusted out of the test year. That would allow the Company test year benefits. Public Counsel/TRACER witness, Mr. Carver, would remove the test year costs but leave test year savings. Public Counsel/TRACER contend that the Company proposal would not present any of the ongoing savings to be derived from the restructuring costs when benefits will exceed costs in 1997 and thereafter

The Commission rejects the Company's position that no adjustment is appropriate. The evidence demonstrates that during the test period, costs of implementing the restructuring were greater than any benefits derived. This net cost is embedded in the test year actual results. The Company's stated purposes for the restructuring is to reduce costs and increase efficiency. There is no evidence that efficiency and quality of service are increased. It is inappropriate to include the net cost of restructuring in the test period when on an ongoing basis the Company projects that there will be net savings with an internal rate of return greater than the Commission's authorized return. Commission Staff's position, which treats results as if the restructuring did not take place, is fair. Public Counsel/TRACER's position, which attempts to leave net savings in the test period, cannot be verified. Further, to the extent that savings exist in the future, they will be present in the Company's results and if we continue traditional ratemaking, should be returned to ratepayers through lower rates.

The Commission accepts Commission Staff's adjustment PFA-9 and rejects Public Counsel/TRACER adjustment relating to restructuring. This adjustment increases net operating income by $11,408,953 and decreases rate base by $11,766,524

B. OPEB Curtailment Loss, Adjustments PFA-10

The Company's proposed adjustment restates the effects of restructuring on "Other Post Employment Benefits." Under Statement of Financial Accounting Standards (SFAS) No. 106 of the Financial Accounting Standards Board, a Company is required to recognize a curtailment loss or gain when the Company experiences any event which significantly alters the expected years of future service of active participants. The present value of post-employment benefits is recorded as an expense at the time they are accrued, in order to reflect the Company's long-term obligation. The obligation is valued on the basis of statistical averages of employee service before separation or retirement.

Because the restructuring program resulted in a large number of early retirements -- some 2,200 -- the average future service of Company employees dropped during the test year. As a result, the Company booked a curtailment loss in 1994. The Company proposes an adjustment to reflect the curtailment loss during the test period.

Commission Staff and Public Counsel/TRACER oppose the Company adjustment, contending that the restructure is a one-time event and that savings from restructuring will more than cover additional expense.

The Commission accepts the Commission Staff argument. It finds that the restructuring is a one-time event and that restructuring savings will offset any additional costs. It acknowledges, as the Company argues, that the Company is required to make the adjustment for financial accounting purposes. In accepting the Commission Staff adjustment for restructuring, above, we did acknowledge that savings would grow and expenses would fall, and that savings would thus exceed expenses. That excess, we reason, offsets the proposed adjustment. Therefore we reject the Company's proposed adjustment.

C. Jurisdictional Separations

Washington ratepayers are responsible only for Washington-related expenses and costs. Because the Company operates and uses its facilities in providing interstate communication, the total costs associated with the Company's operation are allocated or "separated" between Washington (intrastate) operations and the Company's interstate operations. The Company results reflect the monthly allocations during the test period.

Commission Staff noted that during the 14 months of information available on the record, intrastate allocation factors trended downward and interstate factors trended upward. Commission Staff contends that because the intrastate allocation factors are trending downward, the test period is not representative of ongoing factors. They contend that their review of Exhibit 722 clearly indicates that trend, which requires the increased allocation of costs to the interstate jurisdiction.

The Company contends that this is error, that there is no reason to support the change except a lower revenue requirement, and that use of a test period is designed to account for such variations. They also contended in a data response that rather than trending, the separations figures are merely "fluctuating."

A test year is used to compare relationships over time for an accurate picture of Company operations. However, when the test year average is inaccurate, it is appropriate to make such adjustments as needed to produce an accurate picture.

Here, Exhibit 722 clearly shows a trend rather than a fluctuation. The Commission finds that the relationship between interstate and intrastate operations has changed, and the relationship during the period that rates resulting from this proceeding may be expected to be effective is more accurately represented by use of the December figures rather than the test year monthly figures. The Commission Staff adjustment is accepted. This shows an increase to net operating income of $6,805,250 and a decrease to net rate base of $35,722,831.

D. External Relations SA-11

This adjustment is made to remove expenses related to company corporate image advertising and related External Affairs supervision. Commission Staff witness Mr. Hua proposes to remove the corporate or image advertising that was not part of Staff's affiliated interest adjustment RSA-5. He also proposes to disallow an allocated share of the supervision in the external relations department. Mr. Hua's original adjustment disallowed substantially more of the costs in the nine categories in this department. He revised his adjustment based on information that the Company eventually supplied.

Ms. Wright rebuts Mr. Hua's adjustment. She argues that public policy type work functions are a necessity in a regulated environment. Her rebuttal testimony (pages 50-52) gives a description of costs included in each of the 9 categories. She states that only one category should be removed from regulated results, and that the Company has removed those costs.

The Commission accepts the Commission Staff proposed adjustment to remove the image advertising but not the allocated supervision. There appears to be little contest as to the specifics of the advertisements in question. Corporate image advertising is not shown to benefit the ratepayers. It is appropriately disallowed in telephone rate cases.[27] The amount of the adjustment to net operating income is $338,911.

E. Promotional Advertising, SA-8

In this adjustment, Commission Staff proposes to disallow $6.3 million in product advertising, contending that the Company has failed to demonstrate that the advertisements generated more revenues than they cost.

The Company responds that this test has never been applied before. Citing an order in WUTC v. Pacific Northwest Bell Telephone Co., Cause No. U-77-87, the Company contends that the appropriate test remains whether advertising encourages the purchase of services that provide a contribution above expenses. To the extent that it does so, says the Company, it should be allowed.

The Commission finds that the advertising in question is directed toward products that will provide a contribution above expenses. Staff does not contend and has not argued that the advertisements were imprudent, unreasonable, wasteful, disproportional to revenues, or flawed in any way -- only that the Company has not demonstrated that they worked by bringing in more revenues than the ads cost.

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[27] See, e.g., Re Illinois Bell Telephone Co., 156 PUR4th 121, 193-194 (1994).

We do not think that is the proper test. Revenues may be difficult to attribute; results may not be immediate. The decisions from other jurisdictions cited by Commission Staff do not support the principles for which they are urged, and the suggested standard is not shown to be appropriate. For these reasons, we reject the Commission Staff proposed adjustment.

F. Interconnection with Independents, PFA-11; C-2

This adjustment related to local exchange interconnection. The parties agreed that the adjustment would be resolved by judicial review of Commission Docket No. UT-941464, and the Company withdrew the adjustment.

G. Compensation Issues

1. Wages and Salaries: RSA-1 and -2; PFA-1 and -2; SA-12; B-2; C-11; C-12; and C-14

The Company proposed several adjustments to payroll expense to pro form the impact of wage or salary increases during or after the test period. Adjustment RSA-1 pro forms the impact of wage increases during the test year for occupational (non-management) employees. RSA-2 pro forms salary increases for management employees that were implemented during the test period. PFA-1 pro forms the impact of a wage increase for occupational employees subsequent to the test period. PFA-2 pro forms salary increases to management employees subsequent to the test period. The Company's proposed adjustments pro form both the operating expenses and the rate base for these increases.

Ms. Erdahl, Staff's witness, states that the test period wages are not representative, in that they contain excessive overtime and an abnormally low level of capitalization. Ms. Erdahl proposes adjustment SA-12 to decrease the level of overtime from that experienced during the test period and to capitalize a greater portion of the total salaries incurred during the test period, reducing test period operating expense. Ms. Erdahl 's normalized levels for overtime and capitalization are based on a two-year average for overtime and a four year average for the capitalization percentage. Ms. Erdahl revised the Company's pro forma adjustments to give effect to her overtime and capitalization adjustment.

Ms. Erdahl also proposes to exclude team and merit awards from base wages used to calculate RSA-1 and -2 and PFA-1 and -2. She argues that these payments are discretionary. She identifies previous Commission orders excluding bonuses from base wages in pro forma calculations. Finally, she proposes to exclude the rate base impact of the Company's proposed pro forma adjustments. Commission Staff argues that it is inappropriate to pro form rate base, citing prior Commission order on the topic.

Public Counsel/TRACER sponsored witness Carver. The witness objects to the Company's presentation on the basis that it is imbalanced. He contends that the Company pro

forms wage rate increases when total payroll costs are declining. As a result, he proposes to reject the Company's PFA-1 and -2 adjustments. He also would reject the rate base impact of adjustments RSA-1 and -2. As does Commission Staff, he contends that the rate base adjustments pro form the effects of "costs" that will never exist. Finally, he proposes adjustments C-11 and -12, to annualize the last quarter of 1994 payroll in lieu of the Company's pro forma payroll.

The Company contends that the Commission Staff and Public Counsel/TRACER adjustments are arbitrary and capricious, and offered without evidence to support normalization.

The Commission in general accepts the Company's presentation on these adjustments. The Commission rejects Commission Staff's proposed adjustment to decrease overtime and increase the capitalization percentage. As Ms. Wright testified (Ex. 154), the use of overtime is a management tool. There appears to be no contention that the Company misused that tool. Further, there is no evidence that the increased level of capitalization, if appropriate, would correspondingly result in lower wage expense

The Commission also rejects Public Counsel/TRACER proposed annualization adjustments. The Commission is not convinced that the end of the year employment is representative of the ongoing level of employment in this proceeding, and believes that the Company presentation reflects a satisfactory relationship

The Commission does accept Commission Staff's proposal to remove bonuses from base wages in the calculation of pro forma wages. The bonuses are discretionary, and are not certain at any level. Further, as discussed later in this Order, the Commission rejects the Company's Team and Merit Awards.

Finally, the Commission agrees with Commission Staff and Public Counsel/TRACER that it is inappropriate to pro form rate base for the wage increase. Such pro forma rate base adjustments would increase rate base for amounts that will never be incurred. Such pro forma rate base adjustments would result in increases to the entire rate base for-- increases in the unit cost of the components. This type of restatement would run counter to the industry's actual historical experience of declining costs

The Commission has recalculated the pro forma payroll adjustments based on the above discussion, as follows: Adjustment RSA-1 decreases NOI by $1,972,844; Adjustment RSA-2 decreases NOI by $747,663; Adjustment PFA-1 decreases NOI by $3,381,860; and Adjustment PFA-2 decreases NOI by $1,482,081.

2. Compensated Absence Adjustment, RSA-12

The Compensated Absence adjustment has to do with paid leave, such as sick leave. The Company books estimated figures monthly, then makes true-up adjustments to make the test year accurate. In this adjustment, the Company proposes to adjust the test year expense to the actual amount incurred during that year. Commission Staff contests the adjustment, contending that it is selective and to the ratepayers' detriment. Commission Staff argues that the monthly accrual amounts represent a more appropriate "going forward" amount. Staff adjusts test year expense to this level

Here, the Commission accepts Ms. Wright's representation that the true-up adjustments are accurate, and accepts the test year employment level as sufficient for regulatory purposes. The Commission accepts this Company-proposed adjustment, which reduces NOI by $390,000.

3. Team and Merit Awards/TPA, RSA-13

a. Team Awards

During the test period, the Company awarded employee bonuses called Team Performance Awards based on Company performance. The total award was based on customer service measures; quality indicators; Company net income; and business units. During 1994, no payment was made for the service quality component. The Company, through Ms. Wright, proposes adjustment RSA-13 to restate this expense to the level paid for the test period.

Commission Staff proposes to disallow the team and merit awards. Ms. Erdahl's presentation makes it clear that a portion of the awards were accrued for customer service and quality indicators (Ex. 670); Commission Staff witness Beaton proposes that these amounts should be disallowed. The remaining $5.9 million allocated to Washington intrastate operations are awarded based on USWC net income and business unit results (see Ex.662, p. 25). Ms. Erdahl states that these awards, based on USWC results, do not benefit the Washington ratepayer.

Commission Staff argues that the Company has not demonstrated that the events that raise net income benefit the ratepayers. Commission Staff states that net income and customer service are often at cross-purposes with each other, and point to their contention that service quality is deteriorating.

The Company contends that the disallowance should be rejected because it is contrary to the evidence; contrary to well-established precedent; and contrary to sound compensation practices. USWC witness Paul Gobat contended that the Team and Merit awards are an integral and significant portion of management wages for USWC. He states that USWC compensation is reasonable -- in fact, lower than the market average. He states that awards based on net income are beneficial to ratepayers, and that 50% of the scheduled awards were based on

quality indicators and customer service. Ms. Wright also addresses this issue and presents a sample of how the team awards are granted. She states that goals related to net income are beneficial to ratepayers because the increase in net income is created by employees working to reduce costs, and reduced costs result in reduced need to increase rates.

The Commission finds that the team and merit awards have not been shown to benefit the ratepayer, and accepts the Staff-proposed adjustment. As the Company notes, award programs have been accepted as proper expenses for ratemaking purposes by this and other public utility commissions. This Commission has observed that management should have the flexibility to reward good performance and productivity increases[28] and has accepted a program that it observed was not perfect.[29] In the latter proceeding, however, the Commission gave a clear message as to its view of the purpose and structure of an allowable plan:[30]

> The Commission does agree with Staff that some of the (Washington Natural Gas Company) incentives fall short in terms of sending employees the message that the purpose of the program is to encourage improved service. The Commission believes, however, that the Company can do a far better job in the future of creating incentives and setting goals that advantage ratepayers as well as shareholders. Such goals might include controlling costs, promoting energy efficiency, providing good customer service, and promoting safety. Plans which do not tie payments to goals that clearly and directly benefit ratepayers will face disallowance in future proceedings. (Emphasis added.)

In the USWC plan, only a portion of the incentives were directly tied to service or service-related elements. The service goals were not met and that portion was not distributed. The income-related portion, however, was met and exceeded. What is particularly objectionable about this plan is not only that the financial incentives were independent of the service incentives, but the program was constructed so that, if the Company exceeded the stated financial goals by only 8%, employees could "replace" all of the bonus that they would "lose" for failure to achieve customer service goals (Ex. 189, fourth and twelfth pages).

As the Commission noted in the Washington Natural Gas order cited above, there is a potential tension between service quality and earnings. A firm can concentrate on financial elements so heavily that it can lose sight of the importance of providing customer service. In a public utility service, where many customers have no reasonably substitutable alternatives, the

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[28] WUTC v. Pacific Power & Light Co., Cause No. U-86-02 (1986).

[29] WUTC v. Washington Natural Gas Co., Docket No. UG-920840, 4th Supp. Order (1993)

[30] Id., page 19.

Commission must substitute for the competitive market in assuring that customer service remains a priority to the business. Financial goals are at best a very crude way to measure specific efficiencies that employees can accomplish

The Commission finds that the Company's team award plan is not acceptable because, with a structure allowing financial rewards to eclipse customer service failures, it sends the message to employees that service quality is much less important than financial performance. This provides motivation to choose cost saving measures that unduly compromise service quality. The Company plan fails to tie payments to goals that clearly and directly benefit ratepayers. The Company's service quality clearly failed to meet acceptable standards during the test period, as discussed above, while the Company exceeded its financial goals. Whether or not the structure of team awards contributed to this circumstance, it is certainly consistent with the circumstance.

Problems with the plan could be corrected in many ways, including the payment of financial performance awards only after service quality goals are met; tying the amount of awards for other indices to service quality performance, or tying financial-based awards not to the bottom line but to objective employee performance that promotes both efficiencies and customer service. For this proceeding, the Commission accepts the Commission Staff adjustment.

b. "Merit" Awards

Commission Staff's proposed adjustment also would disallow merit awards granted to individual employees.

Merit awards to individual employees, which are clearly based on the evaluation of employee performance upon appropriate standards, should not ordinarily be second-guessed or micromanaged by a regulator. The use of merit awards and the fairness of their distribution are matters for the Company to decide and for which it will ordinarily reap the positive and the negative consequences. Here, however, Commission Staff calls into question the standards by which the awards are granted.

The Company presented little evidence about those standards, and there may be inconsistencies within that evidence. Commission Staff notes that Ex. 221 defines merit awards using the same criteria as are used to define the team awards in Ex. 189. Ex. 190 does not distinguish between criteria for the two. Ex. 189 states at page 2 that a portion of the team performance award constitutes "discretionary payouts for individual employees" and the segment entitled "salary adjustments" at page 4 of the attachment to Ex. 189 is the fourth page of a Team Performance Award brochure for employees. The information we have of record, therefore, indicates that the criteria for merit awards are the same as the criteria for the team awards -- or that "merit" awards are a portion of the Team Performance Awards and thus entirely dependent upon the criteria we have identified as faulty. Because we have disallowed team awards for the use of improper standards, we accept the Commission Staff adjustment and disallow merit awards on the same basis.

The effect of the team and merit awards adjustment is to increase NOI by $6,384,966.

4. Benefit Expense, RSA-14

This Company-proposed adjustment restates test year expense levels for true-ups made in November and December, 1994. Commission Staff opposes the adjustment, contending that test year capitalization is not representative. Staff also objects to the Company's restatement of rate base in this adjustment because, Staff contends, it is inappropriate to pro form rate base. Because we have accepted the Company's capitalization adjustment, and because the two are related and rise or fall on the same analysis, we accept the Company's adjustment here. We also accept the rate base portion of the adjustment, noting that the adjustment is restating and not pro forma.

5. Other Post Employment Benefits (OPEB), RMA-8

This Company-proposed adjustment restates test year OPEB expenses to reflect this Commission's prior adoption of accrual accounting during 1988 and 1989. The Company's expense level is based on the amortization of the transition benefit obligation over 17.3 years based upon the recommendation of the Company's actuary. Mr. Twitchell for Commission Staff proposes to extend the term of the amortization to 20 years. He contends that the 20-year period is consistent with SFAS 106. Staff also suggests that because of the early retirements during restructuring, the working lives of remaining employees will be longer, and calendar 1994 figures are more representative of post-period employment.

The Commission accepts the Company proposal. Although the Commission Staff concerns may have merit, the Company has presented sufficient evidence of record to support its adjustment and the Commission Staff proposal lacks sufficient specific evidence to support it. The adjustment increases NOI by $97,331 and decreases rage base by $7,036,298.

H. Regulatory Fee RSA-17-9; SA-9

The Commission Staff proposes Adjustment SA-9 to pro form the Company's regulatory fee to the rate case level and the current regulatory fee rate. The Company challenges the Staff proposal, contending that Commission Staff proposes selective true-ups and that the monthly accruals were reasonable when booked. On rebuttal, the Company does propose a small adjustment to correct test year posting errors.

The Commission accepts the Commission Staff proposed pro forma adjustment. It reflects the proper treatment for rate case calculation, as it will best reflect the relationship between revenues and expenses going forward, and thus constitutes a better basis on which to set rates. The effect of this adjustment is an increase in NOI of $178,182.

I. Amortization of Debt Call Premiums, PFA-8

The parties agree, and the Commission finds, that the cost of call premiums paid when the Company retired high-interest funded debt is a proper expense for ratemaking purposes. The Company agrees that this expense may be recovered either through the Company adjustment or, as the Commission Staff suggests, through the use of long term debt rate reflecting the expense.

The Commission finds it more appropriate to include the amortization of these expenses in calculating the cost of long term debt. The Commission therefore accepts the Commission Staff adjustment and will recalculate the long term debt cost rate consistent with the Commission Staff suggestion to include this expense.

J. Capital Recovery, PFA-6, B-3, C-15

This adjustment relates to depreciation rates. The Company has tried to relitigate recently-decided and litigate soon-to-be decided depreciation matters in this proceeding, and the Commission has declined to do so. The Company challenges that refusal, contending that it illegally harms the Company.

The Commission acknowledges that the use of accurate depreciation rates is an important element of ratesetting. The Commission reiterates its prior rulings, however, that it need not relitigate the recently-decided depreciation methodology and rates that the Company sought to support in this proceeding with virtually the same evidence -- word for word -- that the Commission considered in the just-completed interconnection proceeding.

The Commission has also noted that the triennial represcription of lives, involving the Commission, the FCC, and the Company, is underway. It is a consideration of some depreciation elements. Upon conclusion of the represcription process, the Commission will consider adjusting rates if doing so is procedurally appropriate and consistent with regulatory principles.

The Commission sees no reason now to reverse its prior rulings on this matter.

We do note that Commission Staff has prepared a pro forma adjustment to implement the depreciation rates found appropriate in Docket No. UT-940641. The Company does not contend that Mr. Spinks' calculation is in error. The Commission will adopt Commission Staff's pro forma adjustment to depreciation expense and accumulated depreciation. The effect of the adjustment is an increase in NOI of $5,049,375 and an increase in rate base of $1,165,240.

IV. Affiliated Transactions

A. General Considerations.

The Company purchases a number of services from companies that are affiliates. Affiliated interest transactions have long been subject to particular scrutiny in utility regulation, both in this state and in other jurisdictions. A company might be tempted to divert functions to unregulated affiliates so that stockholders might earn a higher unregulated return from the affiliate than they might from a regulated entity, with ratepayers consequently responsible for higher expenses than might be experienced in an integrated regulated company. Courts also point to the lack of an arms-length relationship between contracting affiliates, and the resulting temptation to avoid hard bargaining that might be available in a competitive environment.

In Washington State, the Commission has consistently used RCW 80.16.030[31] to protect ratepayers from possible harm from affiliated transactions. The regulated company bears the burden of demonstrating that the payment is a reasonable amount; if it does not do so, or if it does not show the cost to the affiliate of rendering service, the Commission is instructed to disallow payment.[32] The standard for a reasonable price is the lower of the competitive market price or the affiliate's costs plus a fair return [33]

This record presents evidence regarding affiliated transactions with Marketing Resource Group (MRG), to which the Company sells billing and collection services, publisher products, and directory placement at public pay stations; Business Resources, Inc. (BRI), from which the Company purchases procurement, warehousing, and delivery services; with Bellcore

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[31] The statute reads as follows (emphasis added):
80.16.030 Payments to affiliated interest disallowed if not reasonable. In any proceeding, whether upon the commission's own motion or upon complaint, involving the rates or practices of any public service company, the commission may exclude from the accounts of such public service company any payment or compensation to an affiliated interest for any services rendered or property or service furnished, as above described, under existing contracts or arrangements with such affiliated interest unless such public service company shall establish the reasonableness of such payment or compensation. In such proceeding the commission shall disallow such payment or compensation, in whole or in part, in the absence of satisfactory proof that it is reasonable in amount. In such proceeding any payment or compensation may be disapproved or disallowed by the commission, in whole or in part, unless satisfactory proof is submitted to the commission of the cost to the affiliated interest of rendering the service or furnishing the property or service above described.

[32] RCW 80.16.030

[33] WUTC v. Washington Natural Gas Co., Docket No. UG-911236, Third Supp. Order (Sept., 1992).

and US WEST Advanced Technologies (USWAT), from which it purchases research and development; and with US WEST, Inc. (USWI), from which it purchases various management services.

B. Marketing Resource Group, SA-4 and C-4

The Company receives revenues from an agreement with MRG for services that it provides: billing and collection, publisher products, and directory placement at pay phones It records some of the revenues that it receives for this service -- cost, including a return -- as operating income. However, when revenues exceed costs, it records the excess revenues below the line, not considering them as income for purposes of regulation.

Commission Staff and Public Counsel/TRACER would make adjustments to consider the below the line revenues for ratemaking purposes. The Company challenges the adjustments and defends its approach, contending that it is merely following accounting practices established by the Federal Communications Commission (FCC) that the Commission has adopted.

Commission Staff and Public Counsel/TRACER contend that the requirement to use FCC accounting for book purposes does not govern accounting analysis for rate of return regulatory practices, noting that the FCC rules do not constrain USWI from incurring costs for image advertising, lobbying, and charitable contributions. Public Counsel witness, Mr. Brosch, noted that the services are part of MRG's costs and are deducted from the imputation, so should be reflected as income to USWC. (Ex. 390-T, p. 111)

The Commission finds no facts, no rationale, and no citations of authority, to indicate that the Company's accounting practice is appropriate for ratemaking purposes. Accounting for book purposes, even pursuant to rules that the Commission has established or adopted by reference, does not control accounting for ratemaking purposes. WAC 480-120-031(1)[34] All the revenues from MRG for those functions should be considered above the line revenues for ratemaking purposes. The revenues relate to a formerly proprietary function, a regulatory asset, that the Company transferred without compensation. Under the Company's proposed treatment, the ratepayers would not only be deprived of the revenues from earnings, but also deprived of the full benefit of payment for services it formerly performed for itself, thus losing twice. The Commission accepts Commission Staff's calculation of the adjustment, virtually identical to that of Public counsel/Tracer, increasing NOI by $1,052,896.

C. Business Resources, Inc. (BRI), SA-7

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[34] WAC 480-120-031 reads in part as follows:
The accounting rules for book and recording purposes do not dictate intrastate ratemaking.

USWC purchases procurement, warehousing, and delivery services from BRI. Commission Staff contends that alternative services are available from other vendors at a much lower cost than USWC paid to BRI. It calculated the affiliate's costs plus a fair return, and it considered the price of alternative resources based upon Company studies. In proposing its adjustment SA-7, it used estimates of market price based upon a 1988 Company study. It proposes an adjustment of $2,374,375 to net operating income based upon its analysis.

USWC challenges the adjustment, contending that the underlying information that Staff uses is out of date and, in any event, that it is entitled to consider non-cost factors such as the affiliate's track record and its understanding of Company procedures. It notes that the Commission as a State agency is entitled to consider non-cost factors in its procurement.

The analogy with Washington State procurement requirements is not well-taken. The issue is not whether the Company is entitled to enter a contract with an entity other than the lowest bidder. The Commission acknowledges that the Company can lawfully enter a contract for services with virtually whomever it chooses -- in most circumstances with limited Commission review. That is a management prerogative with which the Commission is loath to interfere. The question here is not entry of a contract, but allowance of expenses for ratemaking purposes. The contention that BRI is better because of its history with the Company is entitled to little weight because any contractor might be expected to develop a track record and understanding of Company procedures if given the opportunity. The Company provides no objective evidence demonstrating BRI's superiority or justifying the additional expense. Nor, as the Company appears to allege, is the issue whether BRI overcharged USWC.

Instead, the issue is the financial consequences of such a contract and whether payments under the contract are reasonable by the objective standard stated above.[35] Here, we find that the Company has not demonstrated that the payment is reasonable under pertinent standards.

The Company challenges use of the 1988 study as outdated, contending that it fails to provide an accurate picture of market prices and that its 1990 study is better. Commission Staff responds, and we find, that the 1990 study is flawed and appears to contain double loadings. Therefore, it should be excluded.

The Commission accepts the Commission Staff use of the competitive bids for purposes of pricing the affiliated interest transaction.[36] The Commission finds the testimony of Ms. Strain credible in support of this adjustment

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[35] Commission Staff does not allege that the contract payments are imprudent.

[36] Use of comparable prices requires considerable judgment. Comparable prices are based on estimates that the Company gains from businesses who may look at the relationship between USWC and BRI, as well as the history of the contractual relationship, and perceive that they have no realistic chance of securing USWC 's business

In conclusion, because the transaction is with an affiliate, the Commission may look to the lower of the affiliate's costs or the market price for comparable services to establish the reasonableness of the charges. Here, the credible information as to market prices is the 1988 study and Ms. Strain's testimony. USWC contends that it is entitled to recognition of higher payments because it believes BRI provides better service than a low bidder might, but it provides little evidence beyond conclusory statements that BRI knows a great deal about USWC's business. The burden of proof to justify affiliated interest transactions is higher than such bare allegations.

D. Research and Development, SA-7, C-6, C-7, and RSA-10

No party challenges the generic propriety of research and development expenses for the Company's operations. It must continually look to the future and to its need to maintain its position as a leader in technology, both as an element of its service to present customers and as an element of its preparation for a fully competitive environment.

The issue instead is whether and to what extent ratepayers should fund the activities. Courts have acknowledged the appropriateness of disallowing projects that are unlikely to provide ratepayer benefit[37] or have required a strong showing of benefit to ratepayers in the near future and have categorically disallowed "fundamental research."[38] The parties look to specific elements of the transactions with the two R & D suppliers, Bellcore and USWAT to determine whether the item should be allowed or disallowed.

Commission Staff notes that the Company allocated costs between regulated and unregulated activities by the size of the entities and not the purpose or benefit of the project Commission Staff reviewed the payments, and proposes to disallow many of the expenses and to expense others over their useful life. Staff proposes to disallow 50% of the costs of a number of research projects which, it argues, have deliverable commonalities. Staff criteria for decision included whether an individual project had benefit to Company operations that are now deregulated or that provide no perceived benefit to current ratepayers for regulated tariff service. (Ex. 631-T, p. 17)

Public Counsel/TRACER witness, Mr. Brosch, discusses the costs associated with research and development by USWC affiliates U S WEST Advanced Technologies (USWAT) and Bell Communications Research, Inc. (Bellcore) on page 63 of his testimony. The projects he removed dealt with multimedia services, future video, and broadband and wireless network technologies. As does Commission Staff, he finds that many of the projects undertaken by these affiliates do not have current ratepayer benefits. Many of the projects either extend to

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[37] See, Re USWC, 142 PUR 4th 1, 29-31 (Utah P.S.C., 1993

[38] See, Re AT&T Communications, 107 PUR4th 381 (La. P.S.C., 1989).

nonregulated activities or relate to services far beyond the potential of current telephone technology. His disallowance proposals suggest that if at some future time the Company can demonstrate that these projects do benefit ratepayers, they should be allowed to request recovery of the costs with interest. A side record would be kept to track potential future recovery. As documentation he provides Exhibits 394, 395 and 396 to show descriptions of the contested projects. On rebuttal, he states that his adjustments on Bellcore, USWAT, and the parent vary from staff's mainly on the basis of scope. He believes his position to be more conservative than that of Commission Staff.

Public Counsel/TRACER argue that research and development costs should be recovered only if reasonable. They identify four issues that must be resolved to determine reasonableness: Is there a mismatch of cost and benefit? Do unregulated operations benefit? Is there subsidization of business risk? and, Is the research unsuccessful? Public Counsel refer to a Utah order, which required deferral of certain portions of these costs.

US WEST cites WUTC v. Puget Sound Power & Light Co., 74 PUR 4th 536, 576, 577 (1986) for the proposition that there is necessarily a lag of time, perhaps years, between the investment in research and development and the realization of benefits, and that the Commission considers research and development investment to be socially beneficial, valuable to ratepayers, and pertinent to the Company's needs. USWC contends that it is similarly situated. The Commission disagrees. Differences include the relationship between the contracting parties -- in the Puget case the research was provided by a non-affiliated entity, EPRI (Electric Power Research Institute). Factors also include the nature of the industries; at the time of the order, electric companies were fully regulated and there was no hint that elements would be deregulated. Here, many aspects of telecommunications are deregulated, others are subject to substantial deregulation, and the future appears to hold the promise of additional deregulation. The Commission finds, as pointed out by both Commission Staff and Public Counsel/TRACER witnesses, that it is a very real concern that telephone company ratepayers of regulated services could be charged for research benefiting only the Company or users of deregulated services. While the Commission still subscribes to the basic principles in the Puget order, and will allow costs for projects that appear to have value for ratepayers, the language in Puget cannot be uncritically applied to justify any expense, however unrelated to regulated operations.

The Company contends that it is impossible to determine now what activities might be deregulated in the future by the legislature; that all but a few are now regulated; and that all of the research will be beneficial to ratepayers. It contends that the deferral suggested by Public Counsel/TRACER is unauthorized by law and that future recovery is illusory because single issue ratemaking and retroactive ratemaking are not permitted.

The Commission accepts the Public Counsel/TRACER approach to both Bellcore and USWAT. We prefer it to Commission Staff's similar approach because it is more clearly documented and offers long-term opportunity for recovery. We find no legal bar to using a side record for potential recovery. We find that it is specific as to project, so that benefit will be

simple to determine. The approach will allow the Company to recover the costs of many projects immediately and will allow the full recovery of all deferred projects that prove beneficial to regulated operations -- in a manner that is not retroactive ratemaking, but that allows recovery on a prospective basis when benefit is determined. USWC does not demonstrate that the approach is improper, and side records may, as here, be entirely appropriate for ratemaking purposes.

Accepting the Public Counsel/TRACER adjustment C-6 increases net income by $606,000. Public Counsel/Tracer adjustment C-8 increases NOI by $286,000. Finally, as part of Public Counsel/TRACER presentation, we adopt the company proposed adjustment RSA-10, which increases NOI by $711,913.

E. US WEST, Inc., Adjustments RSA-5A, RSA-5B, and C-8

US WEST, Inc. (USWI) is USWC 's parent and an affiliate of USWC. USWI provides substantial management services to USWC and USWI's other subsidiaries. As listed in Mr. Brosch's testimony, Ex 390-T, page 39. the services include shareholder services; executive management; treasury; legal; strategic marketing; strategic planning; corporate finance; and accounting.

USWI charges USWC for the services that it provides. USWC has recorded these charges as operating expenses, and in adjustment RSA-5 it proposes to true up expenses occurring within the test year but recorded afterwards

Commission Staff contends that some of the amounts that USWC pays to USWI are improper for ratemaking purposes. Ms. Erdahl does not object to the Company's adjustment, but modifies it to eliminate charges for certain functions provided by USWI: executive management, human resources, public relations, and strategic planning. She contends that the USWI executive management and human resources services overlap functions performed by USWC management (Ex. 272 and 273) that are needed only because USWI is running many corporate entities. It contends that USWI's focus is on the integration of USWC with the USWI "family" and that if USWC were a company standing alone, those functions would not be necessary. The Company has its own executive management and public relations departments, Staff argues, and if USWC were an independent company the USWI functions would be unnecessary. Functions performed by USWI are largely related to unregulated operations, competitive services, support of the parent corporation itself, or are simply not needed because USWC has its own staff able to perform the functions. In addition, Commission Staff has also proposed disallowance of strategic planning involving all USWI subsidiaries and focusing on the future of USWI policy positions nationally and internationally, largely in non-regulated areas, and costs related to corporate image advertising and public relations because the Company has not provided sufficient information to demonstrate that any amount of corporate image advertising benefits ratepayers.

On behalf of Public Counsel/TRACER, Mr. Brosch proposes adjustment C-8 to disallow executive management and image advertising costs. He also notes redundancies but not exact duplication of functions between the two affiliates. Instead, Public Counsel/TRACER contend that the holding company imposes some costs that would not be necessary if there were no holding company and that USWC hasn't demonstrated that some of the USWI costs are appropriate for intrastate regulated operations. Mr. Brosch provides a list of services provided by USWI to USWC and states that costs of the new, fast-growing, non-regulated business should not be included in rates for regulated services. He discusses the Regulatory Impact Review (RIR) that was performed in connection with the 14-State Regional Oversight Committee (composed of state commissioners and staff in USWC's service territory), indicating that the review was not intended to take the place of regulatory oversight and did not make recommendations. Public Counsel/TRACER also argue that allocations based on relative affiliate size shifts costs inappropriately to regulated operations because much of the USWI focus is on non-regulated activities. Public Counsel/TRACER contend that the institutional or image advertising fails to provide a direct and primary benefit to the regulated subsidiary

USWC argues that the Commission Staff and Public Counsel/TRACER adjustments are inappropriate. It contends that the Commission Staff and Public Counsel/TRACER positions are based on duplication of functions, and urges that there is no duplication. USWC also contends that the image advertising does promote the growth of the business and therefore should be allowable.

The Company arguments do not directly address the Commission Staff and Public Counsel/TRACER positions. Based on the evidence, the Commission finds that the USWI functions are not entirely duplicative of USWC functions, but that there is substantial overlap and that the challenged USWI functions are directed principally toward "family-wide"' matters rather than USWC issues. USWC has not demonstrated that the overlapping services are reasonable charges to the regulated subsidiary or that they are charged in proportion to the benefits received by the regulated subsidiary. If USWC were a nonaffiliated company, it does appear from the credible testimony of record that those functions could be performed by USWC existing staff or would be unnecessary.

Neither is the Commission persuaded that the costs of image advertising is appropriately borne by ratepayers. The Company contended as to a prior issue, and the Commission agreed, that the appropriate test remains whether advertising encourages the purchase of services that provide a contribution above expenses. Here, there is no evidence that the corporate image expenses meet that test. The Commission believes that the Commission Staff proposed adjustment more accurately removes inappropriate costs, and the Commission accepts the Commission Staff proposed adjustment, which increases NOI by $1,232,375.

V. Taxes

A. Recalculation of Sharing Adjustment, RMA-9, B-4

The Company operated under an alternate form of regulation or AFOR for several years. One element of the AFOR was the sharing of excess earnings. Under that program, the Company and ratepayers shared the benefit of excess earnings according to a prearranged formula. The process was called Sharing and the ratepayer interest was called Sharing Dollars. The Commission designated the distribution of the ratepayer share, and during 1990, 1991, and 1993 used a portion as a credit to depreciation. Under the AFOR settlement, the Company was required to credit accumulated depreciation for an equal portion of the Company's share of excess earnings.

Company witness Ms. Wright proposes adjustment RMA-9, Sharing Adjustment, to give effect to the disposition of sharing dollars through the depreciation reserve for the sharing orders for 1991 and 1992. Her proposed adjustment includes an offset to accumulated depreciation for accumulated deferred taxes. The Company adjustment does not include sharing dollars allocated to accumulated depreciation for 1993.

Commission Staff witness, Mr. Twitchell, discusses the sharing adjustment. His adjustment modifies the Company's adjustment in two respects. First, he includes the 1993 sharing order, which had not been resolved at the time of the Company's filing. The Commission finds this a proper fro forma adjustment to give effect to the 1993 distribution of sharing dollars. The Company did not accept this adjustment but included only 1991 and 1992 sharing results in its presentation and did not address the issue in its brief. Including the 1993 sharing distribution is an appropriate pro forma adjustment and the Commission accepts it.

Second, Mr. Twitchell did not give effect to deferred taxes as the Company proposed. Commission Staff argues that the proposed adjustment to accumulated deferred taxes is not in accordance with previous Commission orders. Staff points out that nothing in the AFOR agreement, or in any of the Commission orders dispersing excess profits, indicates any intent by either the Commission or the Company to offset the adjustments to accumulated depreciation with an adjustment to the accumulated deferred tax balance.

Public Counsel/TRACER witness Carver proposes Adjustment B-4 to accomplish the same functions as the Commission Staff proposal. Public Counsel/TRACER agree that one of the adjustments is needed in order to preserve the ratepayer benefits of the Sharing proceedings. They point out that no Commission order "directed" a deferred tax adjustment associated with the Sharing proceedings, and argue that therefore there is no violation of the Tax Code. They urge, if the Commission rejects the proposed adjustments, that it establish a regulatory liability account not requiring normalization, or that it revisit the Sharing proceedings and consider direct refunds in lieu of depreciation credits.

The Company contends that the sharing orders and the AFOR settlement simply do not address tax consequences, and contends that it must be included now because failure to do so would violate federal law and because ratepayers are not harmed by the partial offset of deferred taxes.

The Commission agrees with Staff that it is appropriate to pro form the effect of the 1993 Sharing dollars into the calculation. However, the Commission must conclude that there should be a tax effect given to these adjustments. The Commission is, however, concerned that the Company's presentation in previous proceedings does not disclose the full nature of these adjustments to accumulated depreciation.

In fact, in two documents of which official notice is taken, a Commission Staff report and a USWC response that led to the 1991 Sharing Order, the following exchange occurred. In Commission Staff's Additional Comments in Response to the Commission's June 6 letter to parties, at page 5, the Commission Staff set out an amortization chart showing the amortization of the depreciation sharing dollars. The chart does not reflect a deferred tax offset. If a deferred tax offset were made, the figures on the chart would be incorrect.

In USWC 's response to the Commission Staff comment, the Company at page 6 acknowledges that the Commission Staff proposal would limit the Company to an 11% rate of return. However, as proposed by Commission Staff, the Company's return may well have been held below 11%. The sharing dollars represent the excess revenues, not the excess net operating income. As such, flow-through just to the depreciation expense without a tax offset would have reduced the Company's earnings below the 11%

Consequently, it appears that it is appropriate to offset the accumulated depreciation with deferred taxes. The Commission recalculates this adjustment based on Ex. 164. The effect of the adjustment is a decrease in rate base of $31,035,616.

B. Sale of Rural Exchanges, PFA-7; SA-6

In Docket No. UT-940701, the Commission accepted a settlement agreement involving the sale of 28 rural exchange properties formerly operated by USWC in Washington State. One element of the settlement was USWC 's pledge to credit depreciation reserve with $16.6 million.

USWC proposes a pro forma adjustment, PFA-7, to give effect to both the removal of the now-sold exchanges and to recognize the disposition of the gain as agreed to in the settlement agreement. One part of adjustment PFA-7 would pro form an offsetting amount for accumulated deferred taxes to the accumulated depreciation credit of $16.6 million. This is similar to USWC's proposal regarding the Sharing Dollar depreciation adjustment. USWC contends that the Internal Revenue Code requires the taxes to be recorded in this manner for ratemaking purposes.

Commission Staff opposes the adjustment. It contends, through Mr. Zawislak, that the settlement agreement does not mention and does not contemplate this offset. Commission Staff argues that the Company's proposal would deprive ratepayers of the benefit of the bargain that the Commission approved. Public Counsel/TRACER urge that the Commission adopt the same approach to this adjustment that it adopts to the Sharing adjustment, next above.

The Commission finds that the circumstances presented here differ from those of the Sharing order. Here, although we have an order that contemplates no offset, we have no pleadings that indicate parties' intent. We have no subsequent orders, and the remedy, effecting the proper tax treatment, is more easily accomplished.

The Company suggests that the credit to the depreciation reserve is the result of a charge to depreciation expense. Thus, per tax regulations, it is necessary to credit deferred taxes and as a result decrease accumulated depreciation and accumulated deferred taxes. However, the Company adjustment does not show an amount for deferred tax expense. The lack of entries associated with depreciation expense is explainable in that the credit to the reserve was by agreement in the settlement, and as with the gain on the sale of the exchanges, is not part of the pro forma adjustment. This is not to say, however, that the depreciation is not related to operations. The same is not true for the deferred taxes. The stipulation made no mention of credits to deferred taxes. The Company's failure to pro form the deferred tax credit is inconsistent with its position that the deferred taxes must be recognized for this depreciation entry.

While the Commission is not certain whether Commission Staff's position would violate the tax code, the Commission will accept the Company's contention in this proceeding. The Commission however, will complete the adjustment and include the credit to deferred tax expense.

The Commission is concerned that the Company negotiated the settlement on the gain on the sale of rural exchanges without revealing the full expected tax consequences of its position, failing to disclose or to make adjustments when timely, then taking no responsibility for consequences when tax implications of the agreement became clear. The Company has an affirmative obligation to disclose such matters to regulators.

The effect of this adjustment is to increase net operating income by $4,210,071 and decrease rate base by $43,542,000.

C. Pension Asset RSA-16

In prior years, the Company over-accrued sums for future pensions, resulting in a pension asset. The Commission Order in Docket Nos. UT-930074/930307/931378 ordered that the Company prospectively flow through the tax consequences of the pension asset. The Company as part of adjustment RSA-16 proposes to remove the previously-deferred taxes from the rate base. USWC contends that the previously deferred amounts were flowed through in the sharing proceedings in 1993 and 1994, and that Commission Staff accepted the entries.

Commission Staff contends that this is an adjustment without substance, arguing that there were no sharing dollars available in 1994. The Company, urges Commission Staff, affords no benefit to ratepayers in this adjustment. Commission Staff proposes instead to pass the benefit of the taxes back to ratepayers over three years, merely making them whole, and preventing the inequity of allowing the Company to benefit from its own booking errors.

The Commission finds that the situation before us results from a Company error, namely, the Company's previous deferral of amounts that should have been flowed through. The Commission finds that it is appropriate to correct it, as suggested by Commission Staff.

Further, the commission order in dockets UT-930074, et al., stated that, "The commission will continue to offset rate base by the unamortized deferred taxes associated with the pension asset.... In either case, ratepayers are given full credit for the deferred tax expense recognized in rates, which has not been paid or obligated to the federal government."

The Commission will adopt in principle Mr. Twitchell's adjustment regarding the deferred taxes associated with the pension asset. That treatment is consistent with the referenced order and with WAC 480-120-031, which requires flow through of these tax benefits. The Commission is aware that the Company did flow through the tax benefits associated with the year 1993 in the sharing proceeding. Therefore, the Commission will only amortize the deferred taxes accumulated through 1992, i.e., $19.4 million on an intrastate basis as determined from Exhibit 323. As a result the Commission rejects the Company's proposed rate base adjustment to remove the entire deferred tax of $22.1 million, and instead revises it to $9,137,758. This amount represents the removal of one year's amortization and the net amounts accrued on the books in 1993 and 1994.

Review of this issue leads the Commission to greater concern about the filings in the Sharing proceedings. The fourth page of Exhibit 323 is a listing of the uncontested adjustments in the 1993 sharing proceeding. On line 16, the adjustment RA-19 Pension Asset Tax Effect shows an increase to rate base of $22.2 million. If this $22.2 million is the deferred taxes of the pension asset, then this adjustment is in direct violation of the excerpt quoted above, which required the deferred taxes to be treated as an offset to rate base.

D. System X Deferred Tax Difference, RSA-16

The Company's separated results of operation contain a current item designated System X deferred Tax difference. Mr. Twitchell, a Commission Staff witness, proposes to remove the item. He states that he asked the Company for an explanation of this item, and that the Company was unable to explain sufficiently what these taxes were. Thus, Mr. Twitchell proposes to remove this item.

Commission Staff argues that this item is included in the Company's tax calculation for regulated operations simply as a plug to balance the separated income tax expense with the total Company level. The Company provides no reconciliation of total regulated taxes to regulated net operating income. Without such a demonstration, Staff recommends that the amount not be allowed

Ms. Wright on rebuttal blames Mr. Twitchell for the disagreement, contending that his failure to understand this accounting entry should be no reason to disallow this expense. She states that the item is a balancing line. She says that taxes are calculated on a total basis, monthly, and that the balancing line is needed for system X because there is a timing difference between the unregulated calculation and the total calculation. The system X is therefore simply a self-correcting entry made to balance the total income tax expense. She further explains that the large $6 million amount was for the most part a result of the November 1993 balancing, which reflected a September 1993 depreciation represcription

The Company argues that the Staff admits that it does not know whether this adjustment is appropriate. They argue that taxes are calculated in total for USWC and then allocated to the various regulatory identifications, including unregulated. They note that the detail from each of the units is not synchronous. They point out that the line item is simply a balancing line used in the allocation due to the asynchronous detail, and that it is ultimately self-correcting. The major portion of the system X item was recorded in November 1993 associated with a September 1993 entry associated with depreciation represcription.

Commission Staff, through Mr. Twitchell, asked for details of the calculation that would enable him to check it. He did not receive the requested information -- except the explanation that it was a figure inserted to make calculations balance.

On brief, the Company runs through its calculation and states that because the four regulatory separations processes governing the calculation are not synchronized, it is necessary to insert a filler that the Company calls a "reconciling adjustment." The Company supports the number with the contention that it is reasonable because the taxes removed are proportional to total company taxes as deregulated products are to company total income. The Company on brief again accuses the Commission Staff of "lack of understanding". The Company contends that lack of understanding is not substantial evidence that would support the Commission Staff position.

The Commission finds that the Company's explanation is insufficient to allow independent calculation of its adjustment. It finds that the Company inserted the number to make the results balance. It finds that proportionality of the tax is not sufficient to verify the number, as taxes are not shown to be a constant proportion to revenues. The Company provides no evidence that the tax calculation for the regulated operations, absent this balancing amount, is incorrect.

Further, Exhibit 158 refers to an unusually large entry in September 1993 that, when coupled with the asynchronous tax calculations between regulatory units, caused a large entry in November 1993. September 1993 is outside the test period, and test year entries to true up such amounts are not properly representative of test year expenses.

The Commission concludes that the Company has not met its burden of supporting this adjustment, and that it should be disallowed. This is a part of Adjustment RSA-16.

E. Federal Income Tax True-Ups, RSA-7 and RSA-17/OOP-4

The Company proposes these two adjustments to adjust the test year expense for out of period entries. RSA-7 adjusts the test year for an entry in the books made subsequent to the test period but reflective of the test period costs. RSA-17/OOP-4 removes a true up that was booked during the test period but reflective of 1992 costs.

Commission Staff objects to the Company's calculation of these two adjustments in two respects. First, Staff observes that the Company allocates the current tax portion of these true-ups at 41.9% to intrastate. Mr. Twitchell argues that these amounts should be allocated consistently with the underlying revenue and expense, approximately 72%, which would be similar to the allocation of other tax elements. The Company does not explain why there is such a discrepancy in the various allocators. It argues that it is difficult at best to determine the underlying revenues and expense. The Commission will adopt Staff's position on this issue because the Company fails to explain the discrepancy

The second difference that Commission Staff argues is that the deferred tax adjustments related to pre-test year results should not be included in rate base. The Company contends that the Staff is making an inappropriate adjustment because all prior adjustments should be reflected in the account for end-of-period calculation

Here, the Commission finds that the Company is correct. Using the end-of-period totals is appropriate, and the balance sheet is unaffected by the difference between an entry in 1992 and those in 1993.

F. Tax Effect of AFUDC, RMA-3

This Company-proposed adjustment is intended to restate the test year rate base and depreciation expense associated with Allowance for Funds Used During Construction (AFUDC) accrued in a side record related to short term Construction Work in Progress (CWIP).

Commission Staff proposes to offset the Company's adjustment with deferred taxes based upon its theory that depreciation of AFUDC must generate a reduction in deferred taxes. The Company responds that in order to have a tax effect of depreciation there must be revenue. It cites Ms. Wright's testimony that nonoperating revenues generated these deferred taxes, and it